Office of Chief Counsel Internal Revenue Service

memorandum

CC:LM:NR:DAL:2

TALudeke

date:

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to:

International Group Manager 4508 NWSAT

North Texas District

from:

Todd Ludeke

Attorney

subject.

Section 482 Issue

DISCLOSURE STATEMENT

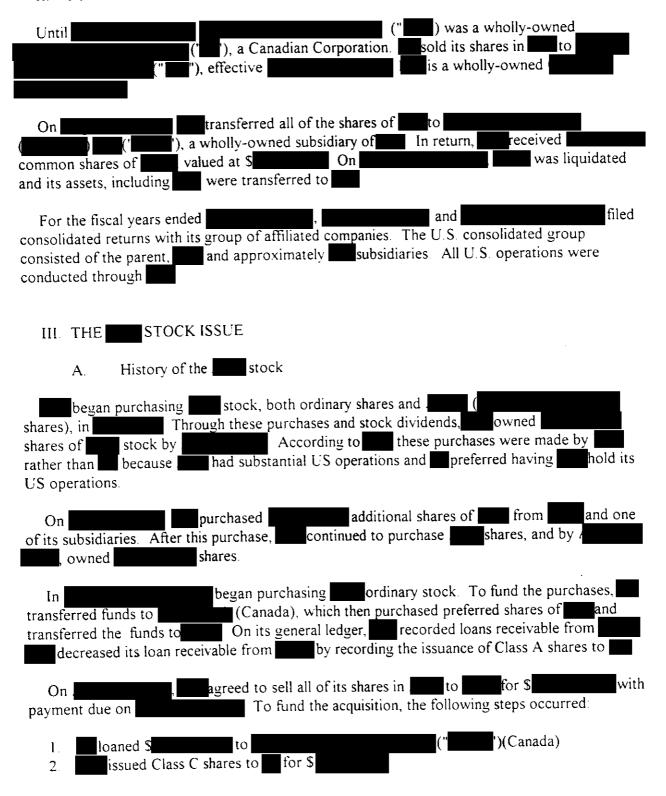
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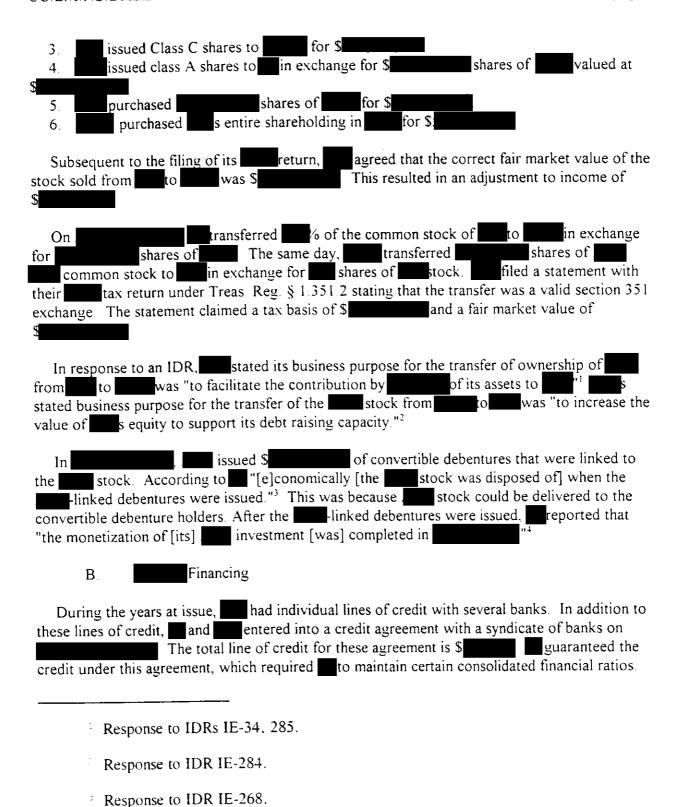
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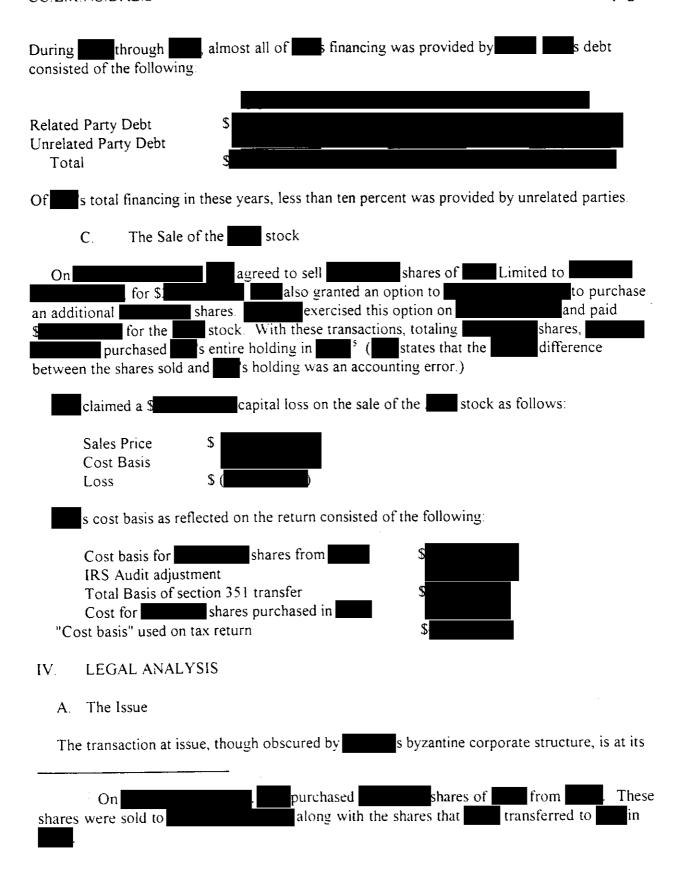
INTRODUCTION

| In | in a section 351 exchange, | transferre | d stock in | from | |
|-----------|---|------------|------------|-------------|-----------|
| | (control to | | | | then sold |
| the | stock at a loss, which it reported on its | return. | This memo | will addres | s that |
| transacti | on | | | | |

II. COMPANY BACKGROUND







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| heart quite simple. began to purchase stock. About a year later, started purchasing the same stock. sold its holdings to stock. After the value of the later |
|--|
| stock declined, transferred its holdings to had originally owned most of the |
| stock it received from in this transfer.) reported no gain or loss on this transfer, which |
| is claimed was a nonrecognition transfer under section 351. About a year after received the |
| stock from the stock was sold to an unrelated third partyclaimed a loss on the sale in |
| excess of \$ Exam proposes allocating the loss to under section 482. |

B. Section 482

Section 482 gives the Commissioner the authority to allocate income among related taxpayers in order to clearly reflect income. Allocations under section 482 must be upheld unless the taxpayer can prove the Commissioner's determination is "arbitrary, capricious, or unreasonable." Eli Lilly & Co. v. Commissioner. 84 T C. 996. 1131 (1985), aff'd in part, rev'd in part, 856 F.2d 855 (7th Cir. 1988). Allocations may be made under section 482 even if the transaction at issue otherwise qualifies for nonrecognition treatment under applicable provisions of the Internal Revenue Code. Treas. Reg. § 1.482-1(f)(1)(iii).

The interaction of section 482 and nonrecognition provisions of the Code has been addressed on several occasions. "National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), aff'g, 46 B.T. A. 562 (1942) is the seminal case in which what is now section 482 was applied in the context of a section 351 transaction for the purpose of preventing the evasion or avoidance of taxes." G.D. Searle & Co. v. Commissioner. 88 T.C. 252, 360 (1987) (notes omitted). National Securities addressed the company's receipt of stock from its parent American Equitable Insurance Company of New York. The stock at issue, in Standard Gas & Electric Company, had a basis of approximately \$120 per share in American's hand. After Standard filed bankruptcy its stock plunged, dropping to \$6.25 per share. After the decline, American transferred 1,000 shares of Standard stock to National Security in exchange for shares in National Security valued at \$8,562.50. Citing the predecessor to section 351 (sections 112(b)(5) and 113(a)(8)), American recognized no gain or loss on the transfer. National sold the standard stock for \$7,175 and claimed a loss of \$133,204.06, which represented the difference between the sales price and the \$140,378.06 Standard basis. The Commissioner disallowed the loss in its entirety.

Arguing that it was entitled to the loss. National contended that section 45 (the predecessor to section 482) could not override the specific nonrecognition provisions of the Code. The Third Circuit disagreed: "[i]n every case in which the section [45] is applied its application will necessarily result in a conflict with the literal requirement of some other provision of [the Internal Revenue Code]." National Securities. 137 F 2d at 603. Analyzing the transaction at issue, the

The Service later conceded that the taxpayer was entitled to a loss of \$1,387.50 - the difference between the market value of the National stock transferred to American and the sales price of the Standard stock.

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court concluded that allowing the subsidiary to deduct a loss that properly belonged to the parent gave "an artificial picture of [the parent's] true income." <u>Id.</u> at 604. And the Commissioner was not required to accept National's claim that it received the stock from the parent because the stock was an unwise investment for an insurance company. Therefore, the Commissioner's allocation was not arbitrary or capricious and the section 482 adjustment was upheld.

In upholding the Commissioner's adjustment the court did not explicitly require that the disallowed transfer have tax avoidance as a motive. The court did note in passing, however, that it appeared that "[American] could not have derived any tax benefit from ... the loss...." <u>Id.</u> at 603, n. 3. And subsequent courts have created an explicit tax-avoidance requirement when addressing the interaction of sections 482 and the nonrecognition provisions of the code.

The most explicit development of the tax-avoidance requirement was in Ruddick Corp. v. United States, 643 F.2d 747 (Cl. Ct. 1981). There the court addressed the transfer of stock via a dividend in 1968 from Ruddoo. Inc. to its parent, R.S. Dickson and Company ("RSD") (which was a wholly-owned subsidiary of Ruddick Corp.). At the time the stock was transferred Ruddoo was profitable, while RSD had a large net operating loss carryforward that would expire when Ruddick was reorganized in 1970. After the transfer, in 1969, Ruddoo sold the stock it received from RSD at a considerable gain. Using section 482, the Service allocated the gain to RSD. Both parties filed motions for summary judgment, agreeing, for the purpose of the motions, that at the time of the transfer no sale of the securities was contemplated and that the reorganization was not made with tax avoidance motives. Analyzing the transaction with these agreed facts in mind, the court concluded that section 482 was not intended to overturn the nonrecognition provisions of the Code:

It should be kept in mind that the prime objective of section 482 is to enable the Service to ascertain "the true income picture" and the income which accrued during the fiscal year for the enterprise as a whole. CF. Central Cuba Sugar Co. v. United States, 198 F.2d at 215, 216. To apply section 482 on the present assumptions would be to elevate a purely technical "distortion" permitted by Congress over the economic reality that there was no distortion.

Id. at 754.

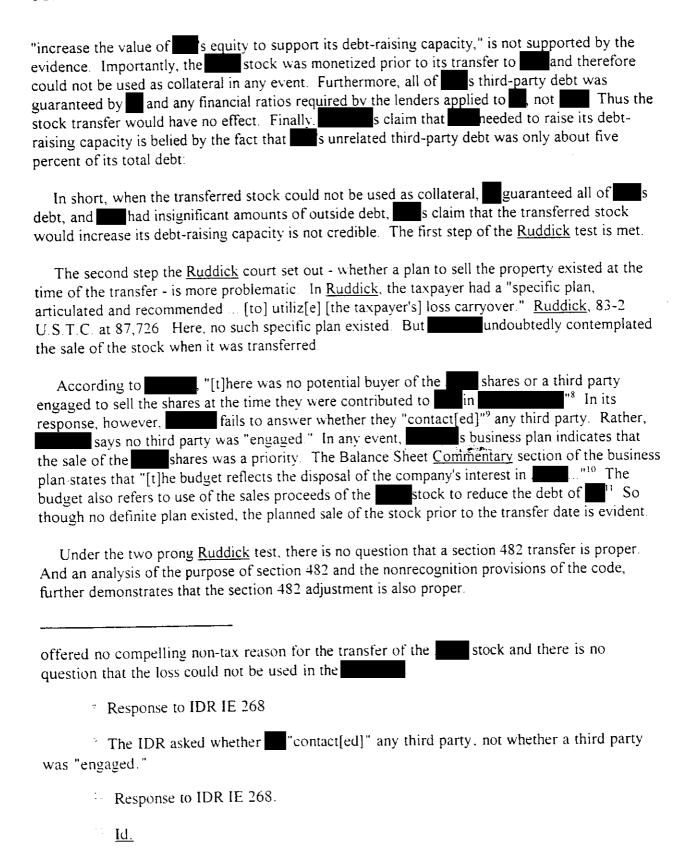
Recognizing the purpose of the nonrecognition provisions, the court concluded that section 482 could not be applied in the absence of taint, tax avoidance, or tax evasion and remanded the case for further factual findings.

On remand, interpreting the decision, the trial court established a test for determining whether a nonrecognition transfer was tainted by tax avoidance or evasion motives. Ruddick Corp. v. United States, 83-2 U.S.T.C. ¶ 9480, aff'd without published opinion, 732 F.2d 168 (Ct. Cl.

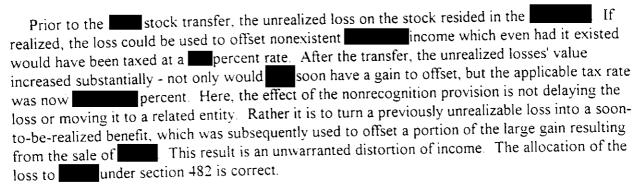
1984). Under that test, a transaction is tainted if (1) the transfer is prompted by tax rather than true business motives and (2) at the time of the transfer there was a plan to sell the transferred property. Applying the test, the court looked at Ruddick's avowed purpose for the dividend which was to increase the capital of RSD. The court found this purpose, which resulted from Ruddick's failure to properly capitalize RSD during a reorganization, flowed from tax-avoidance motives: "The repair of a financial wound that is intentionally self-inflicted is not a business purpose antithetical to garden variety tax maneuvering." Id. at 87,726. Finding that sale of the stock was contemplated prior to the transfer to RSD, the court concluded that the dividend was properly taxable to Ruddoo and upheld the allocation.

The tax evasion / avoidance requirement developed in Ruddick has not always been followed. In Eli Lilly, for example, the court noted that "National Securities and subsequent law make it clear that a valid business purpose will not preclude the application of section 482 in [a case where a nonrecognition provision of the code is involved] when necessary to clearly reflect income." Eli Lilly, 84 T.C. at 1121, n. 57. But even courts that do not require a tax avoidance motive still look to that factor. Southern Bancorporation v. Commissioner, 67 T.C. 1022 (1977) (holding that a valid business purpose would not insulate the taxpayer from a section 482 adjustment but still discussing taxpayer's tax-avoidance motive). So though tax avoidance may not be a prerequisite for a section 482 adjustment, it is an important consideration. With this somewhat conflicting authority in mind, the transaction will be examined.

Transaction D. The 's transaction can be examined in light of the test set forth in Ruddick. The first step is whether the transfer is prompted by tax rather than business motives. As in most cases, tax motive is clear - the ability to use a capital loss in excess of \$ that would otherwise And the business purpose, which claims was to remain uselessly in the had no income to offset the loss, which in any event At the time of the transfer. where the maximum tax rate on would be would be far less useful in the percent. Further. had no real business operations that would ever generate any income whatsoever. In fact, about a year after the transfer of the stock, was liquidated and its assets transferred to At the time of the transfer had no capital gain to offset with the loss. But on announced that it was selling a sale which resulted in a capital gain in excess of to has not answered IDRs pertaining to the sale of at this Because time, it is unclear when negotiations to sell began. It is clear, however, from a report that contact with _____occurred at least as early as In any event, even absent further proof of when the negotiations to sell started.



The purpose of section 482 is to clearly reflect income. G.D. Searle, 88 T.C. at 359. ("[R]espondent may make allocations under section 482 among related parties in order to prevent distortion of income."). The purpose of the nonrecognition provisions of the code is to allow taxpayers to postpone the time when gains or losses are recognized or to permit the shifting of income and expenses among related parties. Melvin S. Adess, The Role of Section 482 in Nonrecognition Transactions - The Outer Edges of Its Application, 57 Taxes 946, 948-950 (1979). To determine when section 482 should be applied "it is necessary to examine the cases in which the nonrecognition transaction was effected in a manner producing and unwarranted or impermissible income distortion." Id. at 950. Though unstated, the key to determining whether a particular income distortion in unwarranted or impermissible is whether the income distortion is permanent or temporary. See Ruddick, 643 F.3d at 757, (Kashiwa,, J., concurring in part, dissenting in part)("The total escape of this tax by any of the controlled entities is a material distortion of income and here, taint aside, the Commissioner can allocate the gain..."). In this case, making that decision requires analyzing so position before and after the transfer.



IV. CONCLUSION

